STATE OF NEW YORK DEPARTMENT OF PUBLIC SERVICE

THREE EMPIRE STATE PLAZA, ALBANY, NY 12223

March 9, 1993

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Ms. Donna R. Searcy
Secretary of the Federal
Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

Re: In the Matter of Simplification of the Depreciation Prescription Process - CC Docket 92-296

Dear Secretary Searcy:

Enclosed please find an original and nine copies of Initial Comments of the New York State Department of Public Service on the Second Notice of Proposed Rulemaking in the above captioned proceeding.

Very truly yours,

Penny Rubin

Penny Rubin
Assistant Counsel

Enclosures

cc: Accounting and Audits Division
2000 L Street, N.W.
Washington, DC 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of	)	
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Simplification of the Depreciation Prescription Process	)	CC Docket 92-296
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INITIAL COMMENTS OF THE NEW YORK STATE DEPARTMENT OF PUBLIC SERVICE

INTRODUCTION AND SUMMARY

The New York State Department of Public Service (NYDPS) submits these comments in the above captioned proceeding. In this proceeding, the Federal Communications Commission (Commission) proposes four options for instituting new methods for determining depreciation expense for American Telephone and Telegraph, Alascom Inc., and 33 local exchange carriers (LECs).

Under the first option, the Basic Factors Range Option, the Commission would establish ranges for the basic factors which determine the parameters used in the present depreciation formula. The carriers would no longer be required to submit detailed studies in support of their proposed factors. Under the second option, the Range of Rates Option, the present depreciation formula would not be used. Instead, a range of rates would be established based on a statistical analysis of currently prescribed rates. Under the third option, the Depreciation Schedule Option, the Commission would establish a depreciation schedule for each account based on industry wide data on service life, retirement pattern and salvage value to be applied to carrier investment by vintage. Under the final proposal, the Price Cap Option, price cap carriers would file their own depreciation rates and would not be required to file supporting data. The Commission would prescribe rates based on the proposals and any comments it received in response.

The Commission also seeks comment on whether the calculation of net salvage value, included in the present depreciation process and each of the four options, should be eliminated.

The NYDPS generally supports efforts to reduce unnecessary regulatory burdens and their associated costs. We support further investigation of the Commission's proposal to remove net salvage from the depreciation prescription process as its calculation is costly and speculative. However, the other proposals put forth in this Notice of Proposed Rulemaking (NPRM) are, with respect to the LECs, premature. They significantly reduce regulatory oversight of the LECs before the competitive market has developed enough to adequately protect ratepayers. Moreover, no significant cost savings would result from the implementation of any of the four proposed options.

COMPETITION HAS NOT YET ADVANCED FAR ENOUGH TO SUPPLANT TRADITIONAL REGULATION OF DEPRECIATION

NYDPS disagrees with the Commission's conclusion that a "keen regulatory eye" is no longer necessary to ensure reasonable charges to ratepayers (NPRM, p. 4). While a competitive telecommunications market may someday eliminate the need for strict regulation of depreciation, the market in which the LECs affected by this NPRM operate is not yet sufficiently competitive to relax regulatory oversight to the extent contemplated.

While competition is beginning to emerge in some aspects of the LECs business, others, such as residential local service, remain a monopoly. As long as there are captive ratepayers of a monopoly, regulators must provide strict oversight. In fact, where a company operates in both a competitive and regulated environment, regulatory review is even more important in order to prevent inappropriate subsidies of competitive services by monopoly ratepayers. The absence of both strong competitive pressure and robust regulation could result in companies choosing depreciation rates which are not in the public interest.

For instance, absent the pressures of a competitive market, the companies could use the flexibility granted to them under the proposals to understate their depreciation expense and, in many instances, continue to increase their already significant depreciation reserve imbalances. For example, before the Commission adopted price cap regulation, which treats depreciation as an endogenous expense, New York Telephone Company (NYT) had been able to recover increased interstate depreciation expense through an annual interstate access charge filing. Under price cap regulation, however, the company can increase its earnings by holding down depreciation expense or other elements of its revenue requirement. NYT recently submitted a depreciation proposal which would have decreased depreciation expense by extending the amortization period of certain accounts, essentially deferring a portion of the expense to increase earnings in the short term.[1/]

The Commission properly rejected NYT's request stating the proposal would:

> result in a significant increase in New York Telephone's depreciation reserve deficiency. In its filing, New York Telephone claimed that it had a reserve deficiency in excess of $1 billion as of January 1, 1992. We find that it would not be appropriate to add to that deficiency by adopting New York Telephone's proposal, which would decrease the carrier's depreciation expense over the next three years.[2/]

Despite the Commission's conclusions that the proposed reduction in depreciation expense was not appropriate, under the proposals outlined in the NPRM, the company would have considerable flexibility to implement its proposed change.

[1/] Federal Communications Commission, In the Matter of the Prescription of Revised Percentages of Depreciation Pursuant to the Communications Act of 1934, as amended, NYT Filing July 31, 1992.

[2/] FCC 93-40, In the Matter of the Prescription of Revised Percentages of Depreciation Pursuant to the Communications Act of 1934, as amended, adopted January 15, 1993 and released January 15, 1993, paragraph 9.

THE ESTIMATED COSTS OF THE DEPRECIATION CALCULATION PROCESS ARE INACCURATE AND MISLEADING

The conclusion that the present depreciation review process is too costly, and therefore should be changed, is based upon industry estimates that the process costs $35 to $50 million industry-wide (NPRM, p. 4). But these estimates, one provided to Commission Staff by the United States Telephone Association and one by the telephone industry to the Office of Domestic Policy and Vice President Quayle's Council on Competitiveness, seem unrealistic (NPRM, p. 4). It is likely that they include the costs of recordkeeping and accounting functions which will still be required under the Uniform System of Accounts and under any of the alternatives proposed in the NPRM.

Costs associated with depreciation analysis represent a very small expenditure in relation to total depreciation expense. For the calendar year 1991, the major telephone companies reported depreciation expense totalling more than $16 billion. Given its magnitude, the Commission does not commit an inordinate amount of resources to the review of that expense. We understand that approximately six Commission staff, who are extremely efficient, knowledgeable, and use the latest technology available in their analyses, work on depreciation analysis of the nation's major telephone companies. The relatively small investment of the Commission and the industry in performing depreciation analysis every three years is justified considering the impact that depreciation expense has on rates.

Technology has enabled both the industry and regulators to conduct detailed depreciation studies and examine numerous scenarios, while at the same time rapidly reducing the resources necessary to perform those studies. As plant records have become automated and the data used as input to depreciation studies have become available electronically, the actual depreciation study process has become more accurate and less paper dependent. In fact, in the last few years in New York, we have been able to test various parameters and their impact on depreciation almost instantaneously.

When depreciation studies are completed and printed, they are indeed voluminous. Since the bulk of any study represents computer-generated data, cost savings could be achieved by filing most of the study electronically, reducing the actual printed material to a relatively short written description where necessary.

IT IS UNLIKELY THAT SIGNIFICANT SAVINGS WILL BE ACHIEVED BY THE FOUR PROPOSED OPTIONS

The NPRM requires that, even if the proposed options are adopted, continuing property records be maintained to support future estimates of depreciation expenses (NPRM, p. 9). These records must also be maintained to support a multitude of other financial and operating activities that carriers must perform. Since, the bulk of the cost associated with depreciation prescription have already been invested in the maintenance of those records before the actual depreciation study process has begun, it cannot be avoided by the proposed changes. Moreover, since implementation of any one of the first three options would still require detailed depreciation analysis in order to initially set and appropriately update the parameters used in those options, potential savings will be further reduced.

Potential savings will also be eroded to the extent that some states may continue to require the companies to produce full depreciation studies. Intrastate revenue requirements bear the major portion of depreciation expense, and since depreciation expense is comparable to maintenance expense in its impact on revenue requirement, the level of depreciation expense will continue to be of primary concern to state regulators. In New York State, approximately 71%, or $924 million, of New York Telephone's $1.3 billion in annual total company depreciation expense is allocated to the intrastate jurisdiction. New York has a strong interest in continuing to analyze this significant portion of the company's revenue requirement. In our experience, the resources necessary to perform such analysis are insignificant when compared to the dollar impact depreciation expense has on the industry's overall revenue requirement.

NET SALVAGE SHOULD BE EXCLUDED FROM THE DEPRECIATION PROCESS

The proposal to remove the net salvage calculation from the depreciation process, replacing it with a requirement that carriers book the cost of removal and salvage as current period charges and credits, is welcome and should be pursued.

Determination of net salvage value is one of the most controversial, time consuming and costly components of setting appropriate depreciation rates. Its removal is the only proposed change that would result in significant cost savings.

The traditional net salvage value calculation is speculative and subject to external forces such as labor rates, inflation, and scrap value which are difficult to predict. Eliminating it would stabilize depreciation rates for those accounts where net salvage has been continually changing over a period of years, which results in uncertainty in setting appropriate depreciation rates. Eliminating this calculation would allow carriers and regulators to spread depreciation expense over the life of associated equipment in a more even, precise, and accurate manner.

Further, the removal of net salvage would reduce depreciation reserve imbalances which are currently inflated by projections of significant expenditures for the costs of removal of outside plant facilities. Removal of net salvage from the calculation would give a clearer picture of the condition of the reserve while allowing carriers to recover actual costs of removal through current year accounting.

The NPRM asks commenters to quantify the effects of the net salvage proposal on carriers' income statements. The NYDPS has conducted a study of this issue for New York's larger carriers. The analysis was based on the comparison of actual booked net salvage with net salvage accruals included in depreciation rates for the period 1983 through 1989. The study indicated that the change would likely have resulted in a reduction in carrier revenue requirement. The revenue requirement for each of the five companies examined was significantly reduced over the seven year period. For example, if the proposed change had been in effect for New York's two largest local exchange carriers, New York Telephone Company and Rochester Telephone Corporation, in 1989, the reduction in revenue requirement would have been approximately $40,000,000 and $2,000,000, respectively.

However, no change in the treatment of salvage should be made until a full examination of all accounting issues has been completed, including whether the change is compatible with Generally Accepted Accounting Principles (GAAP).

NONE OF THE FOUR OPTIONS SHOULD BE ADOPTED AS PROPOSED

For the reasons stated above, we oppose the application of any of the four options proposed in the NPRM to the LECs. However, if the Commission goes forward with any of the options, we agree that it should do so only on an experimental basis. The options should only be implemented for small accounts with little variance in depreciation rates across the industry. We also agree that some phase-in period should be required for carriers whose present rates are outside of any established ranges so as not to cause significant fluctuations in depreciation expense. We disagree, however, that all carriers should be required to adopt the new methodology if one is chosen by the Commission. Carriers who do not wish to change depreciation practices should not be required to do so.

If the Commission is going to give carriers flexibility to determine their depreciation expense levels, it should also give them the responsibility for the consequences of their decisions. If any of these options are adopted, the Commission must put carriers on notice that any future problems (i.e., depreciation reserve imbalances, stranded investments etc.) resulting from the selections made by the carrier will be borne entirely by the company and not by ratepayers. Carriers should not be allowed to increase reserve imbalances to improve short term earnings, or otherwise manipulate their depreciation expenses, if those balances are to be charged to the ratepayers in the future.

While we think any application of these options to the LECs is premature, the first of the four options, the Basic Factors Range option, is the least objectionable as it continues to rely on the basic components underlying depreciation rates. However, even this proposal gives the carriers ample opportunity to disregard budgetary and historical information that might support different factors than those chosen by the carrier from within the established range.

The Depreciation Rate Range Option should not be adopted. By eliminating the present formula, it destroys the underlying factual basis for depreciation. Depreciation expense would no longer be driven by the factors surrounding the consumption of plant unique to a particular carrier, but rather would be derived from a generic table. The range of rates established would be derived from industry wide data and may reflect a range of reasonableness for depreciation rates for the nation's carriers as a group. But, the rate selected by a carrier within that range could be unreasonable for that individual carrier, given the unique factors surrounding its consumption of plant. In addition, this option should not be adopted until a mechanism has been developed to measure and reconcile any accumulated depreciation imbalance caused by over- or under- accruals of depreciation. Further, rate ranges that encompass one standard deviation below the average and one standard deviation above the average, as proposed by the NPRM, are appropriate only where there is not a wide variance across the industry in the depreciation rates presently used. For those accounts that have wide variances, this option becomes difficult to implement.

The Depreciation Schedule Option should not be adopted as it eliminates any opportunity to tailor depreciation rates to a company's specific needs or construction programs by relying on industry averages for service life, retirement patterns and salvage values. In effect, it assumes that every carrier, large or small, urban or rural, will experience the identical depreciation pattern. Further, like the Depreciation Rate Range

Option, this option should not be implemented without some mechanism to calculate the accumulated reserve imbalance.

The Price Cap Option should also not be adopted. We agree with the concerns expressed by Commissioner Ervin S. Duggan in his Concurring Statement regarding this option. If implemented, depreciation rates might have no basis in fact. While this option may represent one end of the range of possibilities to streamline depreciation prescription, it should not be considered for the LECs. It would effectively end meaningful regulation of depreciation and offer no protection to the ratepayers in the absence of a truly competitive market.

CONCLUSIONS

NYDPS supports further examination of the elimination of the net salvage component from the depreciation process. We do not, however, support any of the four options for changes in the depreciation prescription prices. We do not foresee meaningful savings from any of the four proposals and conclude that it is premature to eliminate essential regulatory oversight of a major component of local exchange carriers' revenue requirement.

Respectfully submitted,

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